QUANTICO
ASSET MANAGEMENT
of Wells Fargo Advisors
Uncommon Sense®

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We hope you are enjoying the Summer, wherever your travels may take you.

The second quarter of 2018 saw a continuation of the choppiness that began in the first quarter. As the strength of corporate earnings permeated through the US market, we saw a strong rebound from the February correction. We continued on the gradual upward interest rate path as the Federal Open Market Committee raised interest rates by another quarter percent at their June meeting, citing sustained strength in the economic fundamentals in the United States. With that as a backdrop, The S&P 500 finished the second quarter with a gain of 3.4% (2.6%YTD), while the S&P 500 Value Index had a quarterly gain of 1.4% (Down 2.2%YTD). The Russell Mid Cap Index finished the second quarter with a gain of 2.8% (2.3% YTD). The Russell Mid Cap Value index finished the quarter with a gain of 2.4% (Down 0.2%YTD). The Quantico Large Cap Model Portfolio finished the quarter with a net gain of 4.1%, (Flat YTD). Our Quantico Mid Cap Model Portfolio had a net gain of 6.4% for the second quarter, gaining 3.4% for the year[1]. From a fundamental standpoint, we continue to trim positions that we feel are getting extended in valuation (while mindful of tax implications) and we are deploying that capital to build and add to positions that have strong brands, competent management, and solid balance sheets. The pessimism in the Consumer Staples sector and Packaged Foods industry helped enable us to build a new position in Campbell's Soup and add to our Hersey's, Kraft Heinz and Smucker's positions. Further, we have started a new position in Cummins Engines, a strong research and development unit for internal combustion engines, as the trade/tariff concerns have provided an attractive entry point. Our theme for this letter will be the "checklist mentality". We also will examine the characteristics of good management, where we see those characteristics in our portfolio companies, and how Warren Buffett embodies those qualities in particular.

But first, as we have in the past, we wanted to use the first part of this letter to conduct a brief review of some of the discussions we have had in previous letters. For this review, we want to briefly touch on the blockchain theme that we discussed in the 4th quarter letter of 2017. As you have likely seen by now, the Bitcoin bubble has popped, down to below $8,000 after reaching a high of over $19,000. While we avoided, and continue to avoid, crypto currencies like the plague, we have expressed the benefits of the underlying blockchain technology. Even as the crypto bubble has popped, the underlying blockchain technology remains a game changer for Artificial Intelligence, Cyber Security, Machine Learning, and Supply Chain Management. In the fourth quarter, we reviewed how this technology underpins strategic imperatives for IBM's Watson, enhancing the operational attractiveness of that line of business for them. IBM continues to leverage this technology in Watson as the Cognitive Solutions segment is showing strong growth. We are also beginning to see this technology become a focus for cloud service providers, namely Oracle. Further, Google has mentioned using it to validate advertising revenue and click identities. The future looks promising for the blockchain, and we expect high powered niche players to begin to be acquired in the near future.

For this letter, we wanted to cover a process and procedure we believe is crucial to success in the investment world (and beyond) and that is "the checklist". I first learned about the importance of checklists as a young Naval Aviator in flight training in Pensacola, Florida in the mid 80's. Back in flight school, we were constantly reminded of the story of Major Ployer Hill, who in 1935 was the Army Air Corps chief of flight tests. Major Hill was the most experienced pilot of his era and was selected to pilot the new B299, the Air Corps' first 4 engine bomber and prototype of the later hugely successful B-17 "Flying Fortress". Major Hill had committed the new take off procedures to memory, but the new air craft had locking mechanisms and he forgot to unlock the elevators, rendering the aircraft unresponsive to pitch. Major Hill and 1 other pilot were killed shortly after takeoff, while trying to get the Boeing 299 multi engine aircraft airborne. The top army brass worried that the aircraft was too complicated to fly, and they debated a solution. However, the pilots knew better and came together to develop the first aviation checklist. The human brain is an incredible organ, but memory capacity and the desire to seek shortcuts can limit optimal performance. This is where the value of the checklist comes in, and just like in aviation, there is also a place for checklists in investment management as well. As Charlie Munger said at the 2007 Wesco Annual meeting:

> "I am a great believer in checklists, solving hard problems by using a checklist. You need to get all the likely and unlikely answers before you; otherwise it's easy to miss something important. How can smart people so often be wrong? They don't do what I'm telling you to do: use a checklist to be sure to get all the main models and use them together in a multi modular way."

We also wanted to give our investors a glimpse of how we use checklists at Quantico. So, this letter is a bit different in format as it is crafted as a checklist of the top qualities that we look for when we consider the quality of management. We will explain the quality, provide an example in the context of one of our portfolio companies, and show where we see this quality within Berkshire Hathaway.

The Management Checklist: (able, honest, and passionate)

1. Strong Management allocates each incremental dollar of capital to the highest and best use.
    a. Since the announcement of the NXP deal, QUALCOMM (QCOM) had experienced several delays; however, CEO Steven Mollenkopf is committed to allocating every dollar of capital where it will be treated best. As a result, the deal was terminated in late July; and QCOM will proceed with a share buyback program (a Dutch auction was just announced to buy back $10 million as this letter goes to press). Operationally, QCOM will focus their strategic efforts on 5G research and development.

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   b. Recently, amid the growing Berkshire Hathaway cash pile, the board has revised the buyback program for Berkshire Hathaway shares down to a simple rule that Berkshire will repurchase shares if both Buffett and Munger agree that it is trading below its intrinsic value, previously this had stood at 120% of book value. Buffett has stubbornly withheld paying dividends, but feels that the collection of stellar companies that Berkshire already holds is a fantastic place to put incremental capital to work.
2. Strong Management is honest, ethical, and accountable for the actions of the entire enterprise.
   a. Taking over for the founder is never easy. Even more difficult can be inheriting the enterprise from someone who faltered in this quest and attempt to right the ship. Tim Cook experienced the former task, while Satya Nadella encountered the latter. Both managers took ownership of the enterprise and carried their respective companies to success by differentiating the company and adapting to new paradigms. Cook pivoted from the creative spectacle that Jobs implemented to running a logistically efficient powerhouse, and by further leveraging the ecosystem Jobs had built to ingrain Apple products in the core of their users' existence. At Microsoft, Nadella built on the roots that Gates had planted while side stepping Steve Ballmer's errors, focusing on computational excellence and efficiency, while pushing that power where the customers wanted to be. Both endeavors required honesty with shareholders to win their trust and patience, as well as ethical and responsible behavior to steward the strategic goals to execution.
   b. Nowhere has Buffett shown more leadership and a commitment to ethical behavior than his rescue of Salomon brothers. In fact, Buffett took his "Buck stops here" mentality directly to Congress on this particular occasion. He took responsibility by recognizing the issue, admitting the errors, and taking ownership of the enterprise and its turnaround. He also forced David Sokol, the then Berkshire heir apparent, to step down after learning he personally purchased Lubrizol stock before lobbying Berkshire to bid for the company. While one of the most visible instances of Buffett's intervention and character, it is indicative of his entire career and leadership style; honest, ethical, responsible.
3. Strong Management protects, nurtures, and carries the brand forward.
   a. It is hard to find a CEO that has mastered brand management and monetizing a brand better than Disney's CEO, Bob Iger. Ever since he took over leading the company from Eisner in 2005, he has focused on building and nurturing Disney's stable of brands. For example, he has developed the brands internally by expanding the "Disney Princesses" and launching "live action" movies of the animated classics (i.e. Cinderella and Beauty and the Beast) and externally, with the Pixar, Lucas Film, and Marvel acquisitions. Disney, led by Iger, is the master of integrating its brands across platforms. For example, Disney has taken the Star Wars brand and developed its Studio business with both sequels and spin offs, its Parks business with expanded Star Wars lands and Star Wars themed events at the parks, Broadcasting with animated Star Wars series such as "Star Wars: the Clone Wars", and Consumer Products/Licensing with the games and toys related to the movies. Leverage of this magnitude is only capable when management is truly a brand ambassador.

   b. We have seen no bigger ambassador for brands than Buffett is of his portfolio companies and subsidiaries. Berkshire has more than 90 operating units including the

BNSF railroad, Geico auto insurance, Dairy Queen, Fruit of the Loom, See's Candies, and a variety of industrial and chemical operations. Buffett also avoids debt and has a rock solid balance sheet with over 110 Billion in cash. As he likes to say:" In times of financial distress, our checks will clear". From eating See's Candies and drinking Cherry Cokes during the annual meeting to wagering Dilly Bars, Warren Buffett uses his now celebrity like status to carry his brands forward, and nurture their success.

4. Strong Management is focused on long term success and is patient in that pursuit.
    a. Johnson & Johnson (JNJ) has had seven CEO's since 1944, with the current CEO, Alex Gorsky, taking over in 2012. Gorsky was chosen to lead the firm based on his ability to execute and leadership skills developed from the military. His executive profile is indicative of JNJ's history of investing for the long term and the behavioral consistency in the leadership ranks. Gorksy is a West Point grad who after 6 years in the army left to start his career in the pharmaceutical industry. He has led JNJ within the parameters of the company's 75 year old credo which talks about the company's responsibility to patients, employees, communities and shareholders. He continues to invest in the company for the long term – taking a look at all divisions and making acquisitions and divestitures as needed and putting in the time and funding to develop innovative products. For example, the company has increased its investment in research & development (+16% in this last quarter) as a result of the tax legislation. While analysts continue to ask whether the company will be divesting any divisions and doing more "financial engineering" to "unlock value", Gorsky always looks long term at the company as a whole. He sees greater value in the company operating as a holistic entity and investing to meet larger health care needs across divisions rather than simply meeting short term benchmarks (which often contradict with long term value). On the year-end call in January, Gorksy commented that sustaining investments in innovation is the most important aspect of their strategy. In the pharmaceutical arena, the majority of the value of a company resides in the long-term and it is important that the CEO embodies that philosophy to remain relevant in the space over time.
    b. Recently Buffett and JP Morgan CEO Jamie Dimon spoke about their campaign to end quarterly earnings projections, as they see it as a distorting short term incentive for management to forgo long term value. From a fundamental standpoint, Buffett has used the philosophy of viewing each investment as if it were a 50 year partnership where neither partner was able to sell. This philosophy has been born out in both his subsidiary acquisitions and his buy and hold strategy for most of Berkshire's portfolio companies.
5. Strong Management develops a deep bench and allows the stars of the organization to shine.
    a. Microsoft has done well to develop a strong stable of talent at the top. As Nadella has steered Microsoft into the future via cloud based computing services, he has brought on and developed talent that increases the chances that this strength continues well after his tenure is complete. With Jason Zander leading the Azure team and James Scott as the Chief Technology Officer, Microsoft has a solid foundation of talent to lead their cloud push and the experience in monetization to translate that push into profit.
    b. This is perhaps the top quality Berkshire Hathaway exhibits of those on the management checklist, as Buffett is famous for letting the stars of his subsidiary companies shine via his hands off approach. This approach, in reality, takes quite a bit of

> discipline and due diligence; the wisdom of Buffet and Munger cultivated through years of experience has formed the foundation for their approach. Further, the Berkshire home office has a deep bench with fantastic operators like Ajit Jain on the insurance side, Greg Abel at Berkshire Energy, and the dynamic investing duo of Todd and Ted. The structure of Berkshire leaves us confident in their future success, regardless of who has the title of Chairman.

As you can see, these qualities extend across sectors and industries. In fact, we were able to draw on multiple examples from the same Quantico portfolio companies, such as Berkshire, Microsoft, Disney, and Johnson & Johnson. The strong showings throughout the fundamental tenets of our investment philosophy (Strong Management, Quality Brand, and Wide Moat) qualify companies for a "Core Holding" designation. As we continue to look to deploy capital in the most efficient ways, we will keep our focus on finding quality managers.

As a testament to the value smart people place in checklists, Buffett announced Atul Gawande as the CEO for the new healthcare entity recently created by Jeff Bezos(Amazon), Jamie Dimon(JPM), and Berkshire. Atul Gawande is a surgeon, a Harvard Professor, and the bestselling author of "The Checklist Manifesto". Larry read this nine years ago near the bottom of the market and found it to be a fascinating and insightful azimuth. We have included a copy for you, we hope you enjoy it.

We end this letter with what we would argue is our mission statement at Quantico Asset Management of Wells Fargo Advisors. We will continue to try to exploit opportunities in the market as excessive fear and irrational exuberance create oversold and overbought security prices. Our job is to identify those opportunities for our clients. If "fear" rears its head, with a corresponding reduction in asset price levels, we will invest excess cash to become fully invested. If "greed" shall resume, increasing asset price levels above fair value, we will accumulate cash by exiting or trimming fully valued positions. Buffett is fond of saying, "[t]he less prudence with which others conduct their affairs, the greater the prudence with which we should conduct our own affairs". We agree.

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What worked for Quantico Large Cap:

1. Under Armour (UAA) – Continued execution of restructuring plan.
2. Seritage Growth Properties (SRG) – Recapture and Re-lease strategy working well.
3. Exxon Mobil (XOM) – Improved oil prices and solid execution.
4. Apple (AAPL) – Continued position building by Buffett.
5. Agnico Eagle Mines (AEM) – Efficient mining operations amid tepid Gold price backdrop.

What didn't work for Quantico Large Cap:

1. Berkshire Hathaway (BRK.B) – Pulled down with Financials as the sector corrected.
2. Celgene (CELG) – Continued pressure on the wet shave market.
3. Edgewell Personal Care (EPC) – Continued pricing pressure from loss leading promotions.
4. IBM (IBM) – Soft guidance and continued turnaround.
5. Hershey (HSY) – Packaged food industry weakness and commodity pricing pressure.

Positions Added: (at attractive valuation)

1. Cummins Engines (CMI) – Top engine maker discounted on trade concerns.
2. Barrick Gold Corp. (ABX) – Tepid Gold price provides discount to efficient mining company.
3. Campbell's Soup Co. (CPB) – Staples sector selloff provides valuable entry into solid brand.

Positions Exited:

1. F-5 Networks (FFIV) – Reached/exceeded price target.
2. Goldcorp (GG) – Exited after turnaround story appreciated.
3. Occidental Petroleum (OXY) – Exited on oil price strength.
4. UGI Corp. (UGI) – Reached/exceeded price target.

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What worked for Quantico Mid Cap:

1. Seritage Growth Properties (SRG) – Recapture and Re-lease strategy working well.
2. Under Armour (UAA) – Continued execution of restructuring plan.
3. Signet Jewelers (SIG) – Executed on modified guidance.
4. MACOM Technology Solutions (MTSI) – Rebound in sentiment and new product introduction.
5. Applied Optoelectronics (AAOI) – Short covering.

What didn't work for Quantico Mid Cap:

1. New Gold (NGD) – Longer production ramp at Rainy River than anticipated.
2. Xperi Corp. (XPER) – Trade concerns slow orders.
3. Acuity Brands (AYI) – CAPEX apprehension due to trade concerns.
4. Del Frisco's Restaurant Group (DFRG) – Oil strength yet to make it to miner's wallets.
5. Greenlight Capital Reinsurance (GLRE) – Einhorn's value portfolio is underperforming.

Positions Added: (at attractive valuation)

- Incyte Corp. (INCY) – Oversold on Jakati/Keytruda trial weakness presented buying opportunity.
- Anixter International (AXE) – Strong brand in the network security industry.
- Campbell's Soup Co. (CPB) – Staples sector selloff provides valuable entry into solid brand.
- Cirrus Logic Inc. (CRUS) – Audio component maker in strong supply chain.
- Hershey (HSY) – Staples sector sell off allowed us to add to Mid.
- US Silica Holdings (SLCA) – Pipeline capacity and industry supply issues present strong upside.
- Patterson UTI Energy (PTEN) – Well run land driller at attractive valuation.

Positions Exited:

- Applied Optoelectronics (AAOI) – Reached/exceeded price target.
- Baker Hughes GE (BHGE) – Reached/exceeded price target.
- Cameco Corp. (CCJ) – Reached/exceeded price target.
- F-5 Networks (FFIV) – Reached/exceeded price target.
- Kirkland Lake Gold (KL) – More attractive mining opportunities from a swap perspective.
- Morningstar Inc. (MORN) – Reached/exceeded price target.
- Ovascience Inc. (OVAS) – Tax-Loss harvest.
- Signet Jewelers (SIG) – Strong rebound with concerns about reigniting credit issues.

In closing, we will continue to invest our clients' money as if it were our own and we also invest significant personal assets alongside our clients in the same strategies.

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1 - Performance figures listed are net of program fees and expenses. Please see composite performance reports for full performance information. Reports are available upon request.

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